Summary

- Too much fund choice can lead to negative outcomes for members.
- Lifestyled defaults remain the best way of keeping DC savers on track.
- More needs to be done about defaults into retirement.
- There are some core fund alternatives worth including.

Long live the default

Why too much fund choice might be doing DC members more harm than good

Generally speaking, as human beings, we like to have choices. We want to pick the car we drive, decide what home to buy, and choose where we go on holiday. When we have choices taken away from us, we tend to get upset.

But at the same time, it is possible to be overwhelmed by choice. Paralysed by the array of options available to the point where we bury our heads in the sand and do nothing at all.

For DC pensions schemes, this paradox raises an interesting question. How much fund choice is too much? Do we give members lots of options – and if so how do we stop them making the wrong calls? Or do we remove choice altogether, and run the risk that members won't be happy?

The problem with choice

There are three main problems with giving DC members choice.

The first is the risk of bad decisions. The fact is, that in the absence of independent financial advice, most people aren't equipped to pick their own stocks effectively. Indeed, research shows time and time again that when people make investment decisions, they tend to do so randomly, and that their risk/return profiles fluctuate year on year.

SSGA head of European DC investment strategy Alistair Byrne explains: "After several decades of the global DC industry trying to educate, we can probably agree that teaching normal people the difference between stocks and bonds is challenging. To get most people to the point where they can pick a portfolio is a waste of valuable time, energy and resource that could be better used elsewhere."

Barnett Waddingham partner Mark Futcher adds: "It is an absolute waste of time and money to try and educate members to make investment decisions. It is an impossible task."

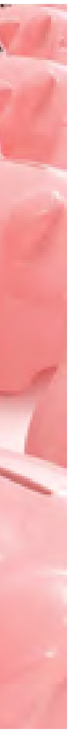
The second issue is that members who self-select their funds do not benefit from the governance and review processes that IGCs and trustees apply to a DC default.

JLT Employee Benefits head of DC investment consulting Maria Nazarova-Doyle says: "If employees take the decision to move away from a default strategy it becomes extremely important that they regularly review their investment choices, the outcomes generated and whether this remains in line with their objectives. Our experience is that a typical employee does not have the self-discipline to take this approach."

Of course, you could try to teach members about investment choices, and governance, to get them into a place where they can manage their own portfolios. But the final problem with choice is that in reality most members don't want to learn.

Xafinity Punter Southall head of national pension trust Dave Hodges says: "It is a fact that over 90 per cent of members still end up in the default fund (obviously some members will actively choose to do so, but the vast majority don't). This is sign of a lack of willingness to engage and a lack of understanding."

In fact, Byrne goes so far as to say



that engagement is likely to lead to worse outcomes for members. He says: "Is it a good thing for people to be engaged and to make choices? Forget what's 'right', the question should be – is it effective? Is it a good way of getting better outcomes? And the answer is – probably not. Good default funds are generally a better answer."

Focusing on defaults to and through retirement

If choices do lead to sub-optimal outcomes, then clearly the focus for most DC schemes should be to create a well-balanced default.

Fortunately, the myth that having too many people in the default is a bad thing has largely been busted. As The People's Pension head of policy and market engagement Darren Philp puts it: "There was sometimes a snobbish stigma attached to being in the default, but that has changed and even schemes with the most engaged members have a large percentage of people in the default fund."

That's good news for the accumulation journey, but how does it marry with 'freedom and choice' at retirement? Clearly, if people are to make good decisions about how they take income once they retire, they need to be super-engaged.

One possible answer lies in providing institutional 'default-style' retirements, particularly necessary for the huge number of people who can't or won't make decisions.

Byrne comments: "Virtually no one can make pathway decisions accurately until they are very close to retirement. Most people cannot even predict within a five-year window when they're going to retire, let alone how. This is why a 'keep your options open' default seems a sensible approach in most cases."

However, many people have embraced the idea of choice, so schemes will need to make sure they provide the tools and education to help retirees through that process.

Getting risk levels right

Of course, if you're going to encourage people into the default, it's important that it works well for your membership, something that lots of schemes are still grappling with.

Nazarova-Doyle believes the answer lies in lifestyling.

She says: "There are a few schemes that we have seen where a low risk investment is used at an early stage, but this has been specifically designed as a result of auto-enrolment and due to the fear of a high opt out rate. However, the nudge of AE worked so well and harnessed the inertia so brilliantly that we have an extremely low opt-out rate. What has also transpired is that auto-enrolled members don't tend to engage with their pensions much at all and therefore are unlikely to track how their investments are performing. So there isn't much basis to deny younger savers investment returns by keeping them in low risk investments for a number of years."

Futcher agrees that scheme design needs to be risk on in the early years. He adds: "The average member does not appreciate the long-term nature of pensions and the ISA mentality can be damaging when translated to pensions. Younger members need to embrace risk and volatility – we don't need to spend money managing volatility many years from retirement."

The necessary choices

Even though choice may be a bad thing for members in terms of outcomes, there are some areas where it is important to make sure there are investment options. In particular, offering alternatives such as shariah or environmental funds.

Hodges explains: "We believe it is important to have these funds as some members will have specific conscientious or religious beliefs that would otherwise stop them from participating in the scheme that their employer has chosen."

However, schemes must also make sure that they're considering ESG factors carefully in the default – simply offering a separate environmental fund won't cut the mustard anymore. As Philp explains: "Evidence suggests that a strong focus on ESG can enhance returns and improve outcomes, and as fund sizes grow, trustees have more bargaining power to make a difference."

There's no ideal mix of funds for every DC scheme or master trust to offer, as what is needed will depend on the characteristics of the workforce. And it's important to regularly review this to understand what the different cohorts might need.

Ensign's scheme secretary, Jenny Evans, explains: "Members should have the right to choose, depending on their own knowledge and understanding, the appropriate investment for them and not be pushed either way but simply be made aware that the choice exists. However, too much choice can be a bad thing. So understanding your member profile and providing carefully researched and selected fund options based on this profile is likely to encourage greater engagement."

And Futcher cautions schemes against adding funds that are faddy rather than right for the membership. He concludes: "Active managers should offer funds where they have the resource and skill required to add value rather than jump on the new trend."

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